Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-5409-98
PBBurns

date:

to: Chief, Examination Division, Southern California District
Attention: Patrick Roecker, International Examiner
Examination Group SP 1410, Laguna Niguel

from: Southern California District Counsel, Laguna Niguel
June Y. Bass, Assistant District Counsel
Paul B. Burns, Special Litigation Assistant

subject: Advisory Opinion re Creditability of Foreign Withholding Taxes
Taxpayer: [redacted] (TIN [redacted])
Taxable Year Ended December 31, [redacted]
Our File No. TL-N-5409-98

THIS ADVICE CONSTITUTES RETURN INFORMATION SUBJECT TO I.R.C. SECTION 6103. THIS ADVICE CONTAINS CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND (IF PREPARED IN ANTICIPATION OF LITIGATION) SUBJECT TO THE ATTORNEY WORK PRODUCT PRIVILEGE. ACCORDINGLY, THE EXAMINATION OR APPEALS RECIPIENT(S) OF THIS DOCUMENT MAY PROVIDE IT ONLY TO THOSE PERSONS WHOSE OFFICIAL TAX ADMINISTRATION DUTIES WITH RESPECT TO THIS CASE REQUIRE SUCH DISCLOSURE. IN NO EVENT MAY THIS DOCUMENT BE PROVIDED TO EXAMINATION, APPEALS, OR OTHER PERSONS BEYOND THOSE SPECIFICALLY INDICATED IN THIS STATEMENT. **THIS ADVICE MAY NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES.**

THIS ADVICE IS NOT BINDING ON EXAMINATION OR APPEALS AND IS NOT A FINAL CASE DETERMINATION. SUCH ADVICE IS ADVISORY AND DOES NOT RESOLVE SERVICE POSITION ON AN ISSUE OR PROVIDE THE BASIS FOR CLOSING A CASE. THE DETERMINATION OF THE SERVICE IN THIS CASE IS TO BE MADE THROUGH THE EXERCISE OF THE INDEPENDENT JUDGMENT OF THE OFFICE WITH JURISDICTION OVER THE CASE.

This is in response to your memorandum dated July 28, 1998 to this office. In your memorandum, you asked that our office review and comment on a proposed explanation of items regarding this case. In a memorandum dated August 31, 1998, we asked that you provide us with certain additional information so that we could complete our response. Some of that information was provided on September 8 and November 5, 1998. You have advised us that you have been unable to obtain all of the information we requested in our August 31, 1998 memorandum from the taxpayer; therefore, at your request and with your permission, we are rendering our opinion based on the available information.

In the draft explanation of items, you propose to disallow the portion of the foreign tax credit claimed by the taxpayer which is attributable to income taxes withheld at the source and paid over to the taxing authorities of Canada and New Zealand by persons who were obligated to pay royalties and fees to the taxpayer, on the ground that the payments were not compulsory. *See* Treas. Reg. § 1.901-2(e).

For the reasons set forth below, it is our opinion that the position set forth in the draft is unlikely to be sustained if it is challenged by the taxpayer, either in Appeals or in litigation. Accordingly, we recommend that you either identify a viable alternative theory which supports disallowance of the credits or allow the credits as claimed.

FACTS

We understand the relevant facts to be as follows.[1]

The taxpayer, [redacted], is a California corporation with its principal office in [redacted], California. During the taxable year at issue, all of the outstanding shares of stock of the taxpayer were owned by [redacted]. During the taxable year at issue, the taxpayer had in effect an election to be treated as an S corporation for Federal income tax purposes.

[redacted] is a [redacted]n addition to making [redacted] the taxpayer has produced a number of [redacted]eaturing [redacted], and [redacted].

---

[1] Our understanding of the facts of this case is limited to the facts set forth in the materials that you made available to us for use in rendering the opinion set forth in this memorandum. We have not conducted any independent investigation into the facts of this case. If the actual facts were to be different from the facts known to us, our legal analysis, and our conclusions and recommendations, might be different. Accordingly, if you learn that the facts known to us are incomplete or incorrect in any material respect, you should not rely on the opinion set forth in this memorandum, and should contact our office for additional assistance.

During the taxable year at issue, the taxpayer entered into an agreement with an unrelated party in New Zealand, pursuant to which [redacted] The taxpayer earned $[redacted] for arranging [redacted]s [redacted] The payor withheld New Zealand income tax at the rate of [redacted] percent on the payment made to the taxpayer.

Also during the taxable year at issue, the taxpayer was a party to an agreement, dated as of [redacted] and captioned "[redacted]," with [redacted], a Canadian corporation ("[redacted]"). Pursuant to the agreement, the taxpayer granted to [redacted] the exclusive right to sell certain "[redacted] products, including [redacted] included Canada, in exchange for payments equal to [redacted] percent of the amounts received by [redacted] as royalties from sub-licensing the products in the territory. The taxpayer earned $[redacted] in royalty income from [redacted] during the taxable year at issue. [redacted] withheld Canadian Federal income tax, at the rate of [redacted] percent, on the royalty payments made to the taxpayer.[2]

LEGAL ANALYSIS

I.R.C. Section 901(b)(1) provides in relevant part that in lieu of claiming a deduction for foreign taxes paid or incurred during the taxable year, a domestic corporation can claim a credit, subject to the limitation imposed by Section 904, equal to the amount of "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country ..." I.R.C. Section 903 provides that the term "income, war profits, and excess profits taxes" includes taxes "paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country ...."

In order to be a creditable tax, a foreign tax must be a tax, and its "predominant character" must be "of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1). You have not raised any issue with respect to whether the income tax imposed by New Zealand or the Federal income tax imposed by Canada are creditable taxes, and in our view it is beyond dispute that both taxes are creditable taxes. *See* Treas. Reg. §§ 1.901-2(a)(3) , 1.901-2(b) (describing an income tax in the U.S. sense as a tax that reaches only realized net income or gain). Similarly, the regulations under

---

[2] In the draft explanation, you also noted that the taxpayer earned $[redacted] during the taxable year at issue for arranging [redacted] in Taiwan, and that Taiwanese tax was withheld, at the rate of [redacted] percent on the payments received from sources in Taiwan. However, you have not proposed to disallow the portion of the foreign tax credit claimed by the taxpayer which is attributable to withholding tax paid to Taiwan. Accordingly, we express no opinion as to whether the credit is properly allowable.

I.R.C. Section 903 make it clear that the withholding taxes imposed by New Zealand and Canada qualify as creditable "in lieu" taxes. *See* Treas. Reg. § 1.903-1(b)(3), examples (1), (2).

Regulations Section 1.901-2(e)(5) provides in relevant part as follows:

> (5) *Noncompulsory amounts*--(i) *In general.* An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). ... A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success.

In our view, neither the withholding tax paid to New Zealand with respect to income earned by the taxpayer for arranging for [redacted] by [redacted] in New Zealand, nor the withholding tax paid to Canada with respect to royalty income earned by the taxpayer on sales of licensed products in Canada, can reasonably be said to be "noncompulsory," within the meaning of the regulations.

New Zealand.

In the draft explanation of items, you took the position that Article 14 of the tax treaty between the United States and New Zealand provides an exemption for the income earned by the taxpayer from arranging for [redacted]'s appearances in New Zealand, because [redacted] was not physically present in New Zealand for at least 183 days during any consecutive 12-month period and had no fixed base in New Zealand. In our view, Article 14 of the treaty is inapplicable to the facts of this case, and the applicable provision of the treaty makes it clear that the payments made to the taxpayer were subject to withholding tax.

New Zealand imposes a 20 percent withholding tax on payments to non-resident sports people, entertainers, and performing artists. *See* New Zealand Department of Inland Revenue, "Visitors' Tax Guide," at [redacted] (1995).[3] [redacted]

[redacted]

[redacted] The income in question was not paid to [redacted], but rather was paid to the taxpayer. Accordingly, it is subject to tax unless [redacted] does not directly or indirectly participate in the profits of the taxpayer. As the sole shareholder of the taxpayer, [redacted] is the only person who is in a position to participate in the profits of the taxpayer. As a result, in our view, if [redacted] is properly treated as an "[redacted]" then New Zealand tax was properly withheld from the amounts paid to the taxpayer.

While it may appear to be a novel or aggressive interpretation of the language of the treaty to classify [redacted] as an "[redacted]" we cannot say that such an interpretation is unreasonable. Finally, given the relatively small amount at stake and the distance involved, we are not prepared to say that the possibility of filing the equivalent of a refund claim in New Zealand is an effective and practical remedy.[4] Accordingly, it is our opinion that the payment of New Zealand withholding tax was not noncompulsory.

---

[3] All of the Inland Revenue publications cited in this memorandum are available on the Internet at http://www.ir.govt.nz.

[4] This is particularly true because of the very short time period allowed under New Zealand law for taxpayers to file the equivalent of a refund claim. Under New Zealand law, the Department of Inland Revenue issues a written notice of assessment to the taxpayer in every case, even when a return is accepted as filed. If a taxpayer wishes to dispute the amount of tax due, as shown on the notice of assessment, the taxpayer must file a Notice of Proposed Adjustment with Inland Revenue within two months after the date of the notice of assessment. *See generally* New Zealand Department of Inland Revenue, Publication IR 210J, "Disputing an Assessment" (1996).

Canada

In the draft explanation of items, you took the position that the royalties paid to the taxpayer by [redacted] were exempt from Canadian tax under Article 12 of the tax treaty between the United States and Canada. In our view, the exemption provided by Section 3 of Article 12 does not apply to the payments in this case.

Section 212(1)(d) of the Income Tax Act generally imposes a tax, at a flat rate of 25 percent (collected by withholding at the source), on the gross amount of rents, royalties, and similar payments received by non-residents of Canada from sources in Canada. Specifically, subparagraph (i) of Section 212(1)(d) covers payments "for the right to use any property, invention, trade mark, design or model, plan, secret formula, process, trade name, patent or other thing whatever." Revenue Canada, Bulletin IT-303, "Know-How and Similar Payments to Non-Residents," ¶ 10 (1976).[5] Subparagraph (ii) covers payments for information "concerning industrial, commercial, or scientific experience" if the consideration paid for the use of the information is dependent in whole or in part on sales of goods or services. Bulletin IT-303, ¶ 14.

The general rule is subject to a number of exceptions, including an exception for "copyright royalties or similar payments relating to the production or reproduction of any literary, dramatic, musical, or artistic work." Revenue Canada, Information Circular 77-16 (Rev. 4), "Non-Resident Income Tax," at 18 ¶ 38(c) (1992).

Article 12(2) of the tax treaty between the United States and Canada provides for a reduced rate of withholding (10 percent) on royalties, while Article 12(3) provides in relevant part that "copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical, or artistic work ... arising in a Contracting State and beneficially owned by a resident of the other Contracting state shall be taxable only in that other State."[6]

In general, Canadian tax jurisprudence is similar to ours in that exemptions from taxation and deductions are narrowly construed, and the person claiming the benefit of an exemption or a deduction bears the burden of showing that they have complied with all requirements imposed by law to obtain it. This principle applies with equal force in the interpretation of statutes and

[5] All of the Revenue Canada publications cited in this memorandum are available on the Internet at http://www.rc.gc.ca.

[6] The amendment to Article 12, Section 3 set forth in the 1995 protocol to the tax treaty between the United States and Canada, which significantly expanded the scope of the exemption for royalties, does not apply to the payments in this case, which were made before it came into force. *See* 1 Warren, Gorham & Lamont, Tax Treaties, ¶ 22,042, fn. 1 (1996).

treaties. *See Western Electric Co., Inc. v. Minister of National Revenue*, 1 C.P.R.2d 185, 1971 CPR LEXIS 199 (Sup. Ct. 1971).[7]

In our view, on the facts of this case it cannot be said that requiring withholding on the payments from [redacted] to the taxpayer is inconsistent with a reasonable interpretation of the applicable Canadian statutes and the treaty. [redacted]

An argument could be made that the tax paid to Canada is noncompulsory, because the taxpayer failed to exhaust his remedies under Canadian law to obtain a refund of the tax. However, we do not believe that this argument would succeed, for two reasons. First, we do not believe that the taxpayer has a good case on the merits, so that the cost of pursuing a refund would not be "reasonable in light of ... the probability of success." Treas. Reg. § 1.901-2(e). Second, under Canadian law the statute of limitations on claims for refund of tax withheld at the source expires two years after the end of the calendar year in which the funds are withheld and paid over. *See* Circular 77-16, ¶ 69. In our view, raising an argument that the credit should be denied, for failure to pursue a refund claim that has a minimal chance of success, at a time when the taxpayer is time-barred from doing so, is likely to be perceived as unfair, and is therefore unlikely to be accepted by Appeals or a court.

CONCLUSION AND RECOMMENDATION

For the reasons set forth above, it is our opinion that the facts of this case and the applicable law do not provide a basis for disallowing the credit claimed by the taxpayer with respect to withholding taxes paid to New Zealand or Canada. We recommend that the draft explanation of items not be issued.

If you have any questions regarding any of the matters discussed in this memorandum, please feel free to call Paul Burns of this office at extension 3439.

JYB:PBB/pbb

---

[7] *But cf. Entré Computer Centers, Inc. v. the Queen*, 1996 Can. Tax. Ct. LEXIS 4768 (Tax Ct. 1996), in which the court applied a substance over form analysis to disregard the language of an amendment to a franchise agreement which designated certain payments as royalties, based on its findings of fact that no know-how was provided by the franchisor and that the payments were designated as royalties primarily to avoid potential problems under U.S. antitrust law.